By the Numbers

By Stephen J. Koca and Richard B. Lord

The MPL Insurance Market: The Clock Is Ticking on Reserve Releases

Since the late 1990s, a cycle generally familiar to the insurance industry has been playing out in the medical professional liability (MPL) market. During the late 1990s and early 2000s, insurers' costs increased rapidly. By 2001, after a bit of a lag, insurers started increasing their pricing. Then, between approximately 2003 and 2007, claim frequency dropped significantly for a number of reasons—patient safety initiatives, tort reform, public sentiment, and others. Meanwhile, net earned premiums continued to rise, peaking in 2006 (Figure 1).

While this was occurring, insurers continued to increase rates, in an effort to correct prior rate inadequacies. As a result, reserves built up, allowing insurers to ease up on premium prices. This set in motion a wave of declining prices, in a fiercely competitive market that continues to this day. The results, in terms of policy writing and profits, have been phenomenal on a calendar-year basis.

However, the price war has escalated to the point where reserve releases have become the primary undergirding of profits. Today's stellar financials are possible only because insurers are still reaping the benefits of the earlier high prices, at the cost of reserves, which have been steadily declining in the most recent years. As of 2010–2011, many analysts began to worry about how long the reliance on reserve releases could continue before the industry would have to increase premiums.[1] On the surface, it might appear that the tide has not yet turned; data from 2011 still indicate a continuing positive financial performance on a calendar-year basis. However, one can see that prior-year reserve releases reduced the underwriting combined ratio by more than 20%, slightly less so than in 2010, but still a significant boon to results (Figure 2).

The bad news, then, is much the same as it was one year ago: on a policy-year basis, there is reason to believe that current pricing, geared to the competitive market but likely inadequate to sustain ongoing profits, will not work much longer. Figure 3 shows how underwriting combined ratios for the industry would look if prior policy-year reserve releases were backed out of the equation. An increase in this ratio in 2009 has remained through 2011, but it is not sustainable in today's investment environment, unless it is buoyed by reserve releases.

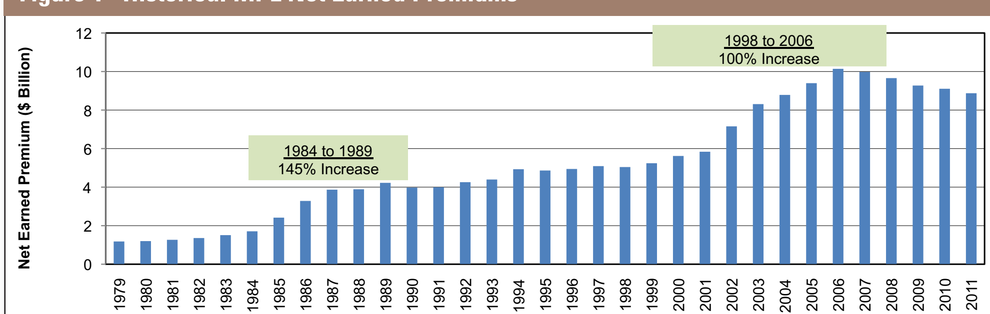
While the loss experience is immature for this calculation, given the fiercely competitive pricing environment, it is likely that these results are more indicative of the actual current results and not of further reserve building that could be released in the future. In other words, the clock may be ticking as to how long reserve releases can buoy calendar-year financial results.

A few factors in the equation

Between 2003 and 2007, claim frequency within the MPL industry dropped by about one-half. We are already beginning to see signs of moderate frequency increases, and it is conceivable that a steeper upturn could suddenly take place, with claim losses increasing significantly in a short period of time. Past history shows a pattern of

***Stephen J. Koca** and **Richard B. Lord** are Principals and Consulting Actuaries with Milliman, Pasadena, California.*

Figure 1 Historical MPL Net Earned Premiums

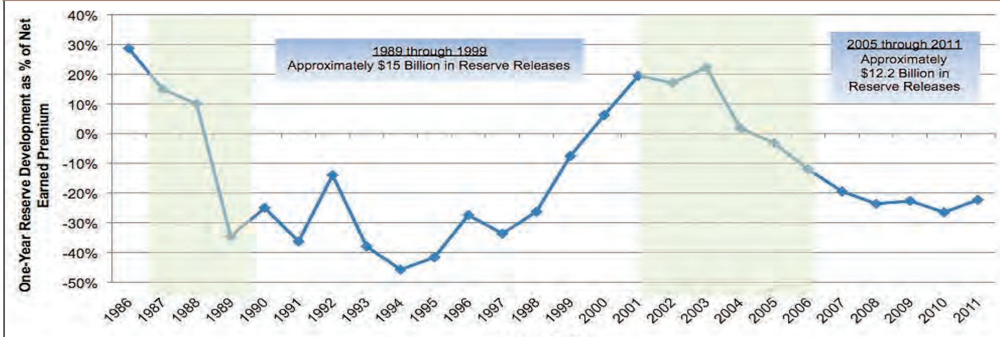


Source: Medical Professional Liability Industry Aggregate, Highline Data / A.M. Best Aggregates & Averages recurring market cycles; it is unlikely that the current holding pattern will persist indefinitely, and the next turn of the cycle will almost certainly be upward.

Meanwhile, since medical costs are a significant portion of total claim costs, the cost of individual claims has been rising in tandem with the steep inflation of healthcare costs. Combine this factor with a significant uptick in claim frequency, and the obvious result would be a strong adverse pressure on insurer financials.

Provider consolidation. A second piece of the puzzle is the trend, in recent years, whereby more and more physicians leave private practice and join large groups or take employment in hospitals. The ultimate effect of this trend on the MPL industry is not yet clear, but as physicians become hospital employees, they are more likely to join their hospital's insurance program than to continue purchasing their own private MPL coverage. The same is true of providers who consolidate their small practices by forming accountable care organizations (ACOs) and other larger-scale provider institutions. That means a decrease in the number of policies physician insurers will be writing.

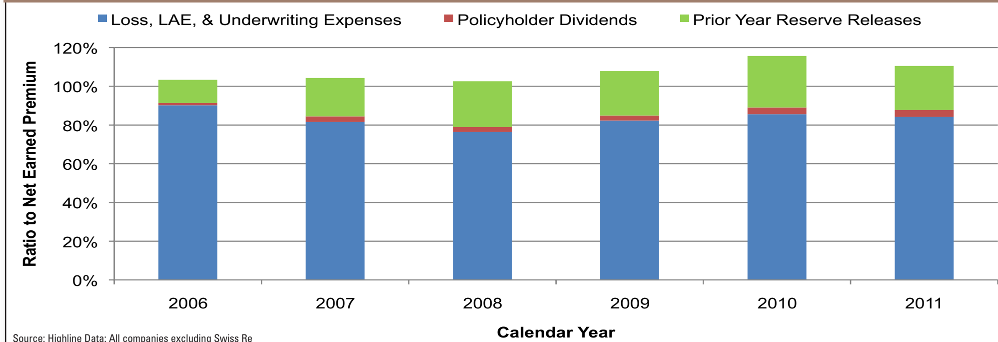
Figure 2 Historical MPL Reserve Changes, as a Percent of Net Earned Premiums



Source: Medical Professional Liability Industry Aggregate, Highline Data / A.M. Best Aggregates & Averages

Shaded areas represent hard market periods

Figure 3 2006–2011 Combined Ratios, Before and After Reserve Releases



Source: Highline Data: All companies excluding Swiss Re

Declining premiums. Figure 1 shows a steady decline in net earned premiums from 2006 through 2011. The most obvious explanation of this decline is the ongoing softness of the market—premium price cuts amid stiff competition—but that may not be the only explanation. Other possibilities are that:

- Provider consolidation and the resulting loss of policies may already be exerting a significant effect on these overall statistics. As more physicians join hospital self-insurance programs or other alternative risk vehicles, their exposure and the related premium may not be included in statutory insurance financials.
- Increases in deductible or self-insured levels among MPL purchasers may also be decreasing the total premiums paid.

Whatever the actual configuration of factors, the trend toward decreased premiums is a warning signal about the sustainability of current price levels, especially in an environment of claims-cost inflation.

Possible effect of healthcare reform

As far as MPL is concerned, little has changed since last year as a direct result of the Patient Protection and Affordable Care Act (PPACA) of 2010. The main impact of the reform legislation awaits its full implementation in 2014.

In a nutshell, if the reform is implemented as called for in the legislation, achieving the goal of a healthier nation could cause healthcare costs to ease somewhat over the long term, because more people will presumably receive regular care and preventive care, and fewer will be requiring higher-cost treatment. The medium-term effect, however, will almost certainly be an increase in the utilization of medical services and, compared with the current situation, a potentially higher proportion of less-healthy participants. This, in turn, could raise the number of MPL claims, putting pressure on loss ratios—just when industry financials may already be entering a difficult period within the market cycle.

Conclusions

Last year, we predicted that "the reserve releases may continue for only another three to four years, declining each year, if the current cycle unfolds similar to the previous one …" Financial performance results from 2011 have not changed our thinking about this.

Insurers need to pay close attention to both calendar- and policy-year results, and to reassess pricing carefully in tune with cost trends. There will be continued pressure to keep premiums low in a market that remains soft, but adequate pricing demands a consciousness that current policies may not be making money. If insurers continue to keep premiums low in order to get more business in the door, it is more than likely that, someday in the not-so-distant future, they will have to raise their prices hastily, and that could turn the market hard in a hurry. PIAA

For related information, see www.www.milliman.com.

Reference

1. Lord RB, Koca SJ. Medical professional liability market: stormy winds begin to blow. Physician Insurer, Third Quarter 2011.